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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1974

**No. 74-1471**

TSC INDUSTRIES, INC., A DELAWARE CORPORATION, NATIONAL INDUSTRIES, INC., A KENTUCKY CORPORATION, AND TSC INDUSTRIES, INC. (FORMERLY NAMED NII, INC., AND BEING THE SUCCESSOR TO THE BUSINESS, ASSETS AND CORPORATE NAME OF SAID TSC INDUSTRIES, INC.)
*Petitioners,*

*vs.*

NORTHWAY, INC., A DELAWARE CORPORATION,
*Respondent.*

## REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

JOSEPH N. MORENCY, JR.,
JAMES T. OTIS,
WESLEY S. WALTON,
JOHN R. F. BAER,
PRICE, CUSHMAN, KECK,
MAHIN & CATE,
8300 Sears Tower,
233 South Wacker Drive,
Chicago, Illinois 60606,
312/876-3400,
*Attorneys for Petitioners.*

Of Counsel:
MILTON V. FREEMAN,
ARNOLD & PORTER,
1229 Nineteenth St., N.W.,
Washington, D. C. 20037.

Gunthorp-Warren Printing Company, Chicago • Financial 6-6565

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## REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

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The determinative differences between the "significant propensity test" enunciated by this Court in *Mills* and the quite different test devised by the Seventh Circuit below cannot be sloughed off. The Seventh Circuit expressly articulated a test of materiality significantly at odds with that adopted by other Courts of Appeal and carefully distinguished its own standard from that stated by the Second Circuit in *Gerstle* and the Fifth Circuit in *Smallwood*. It then proceeded to apply its own test by which "relevancy alone is the critical test of materiality", thereby expressly rejecting application of the *Gerstle* and *Smallwood* test and Mr. Justice

Harlan's concept stated in *Mills* that a material omission must have a "significant propensity to affect the voting process." Accordingly, the Seventh Circuit, applying its relevancy test, found four complained of omissions to be "material", each of which separately or collectively simply could not be found material on summary judgment under the *Gerstle* and *Smallwood* test.

Because of its significant departure from the test articulated in *Mills*, *Gerstle* and *Smallwood*, the Seventh Circuit's test, if left standing, will perpetrate a profound injustice upon the Petitioners herein and, in the future, will have a significantly undesirable effect on the outcome of similar litigation in the Seventh Circuit. Proxy statements will be required to spell out substantial additional material which is "relevant" but nothing more. This is counterproductive to the achievement of clear, concise proxy statements limited to essential elements for shareholder understanding. Under the Seventh Circuit's test this Proxy Statement becomes unlawful and a multi-million dollar transaction is vitiated even though no reasonable shareholder was or should have been misled as to the material elements of and surrounding the transaction.

A.

**This Case Poses an Important Question of Federal Securities Law, Not Merely a Fact Controversy.**

To say that the Seventh Circuit's decision below is a "straightforward application" of *Mills* (Br. 10) distorts *Mills*. Respondent would disregard the expressed intent of this Court, and would deny the normal, clear and obvious meaning of this Court's phrase, "significant *propensity* to affect the voting process." Mr. Justice Harlan indeed took the matter more seriously, choosing the word "propensity" (which Webster's Third New International Dictionary defines as a natural inclination, innate or inherent tendency), and for *special* emphasis italicized and qualified that word with the additional word "significant".



For the Seventh Circuit now to make "relevancy alone" the "critical test of materiality" (A-10, note 13) drastically alters the rules of the game. Necessarily, "significant propensity" excludes from the concept of materiality some relevant facts and limits "material" information to those facts which directly pertain in a meaningful way to the issue being presented to the shareholders.

Nothing in *Mills* broadens the concept of materiality to comprehend all relevant facts regardless of significance. "[S]ignificant propensity" recognizes that, with causation presumed, materiality becomes more important. "[S]ignificant propensity" filters out what "relevancy" would require—omissions too insignificant to have probable impact on the voting process. The Seventh Circuit would destroy the filter.

B.

**The Conflict Among the Circuits Is Clear and Important.**

To say that the only difference between the Seventh Circuit and others is one of "verbal preference", favoring the word "might" over the word "would", is to lose sight of the forest for the trees. The inter-circuit conflict is basic and does not turn simply on the use of the words "might" and "would", at times used simply as convenient nametags for the very different tests applied.

The Second Circuit, by Judge Friendly in *Gerstle*, states in rejecting a "might" standard that "[w]hen account is taken of the heavy damages that may be imposed, a *standard tending toward probability* rather than toward mere possibility is more appropriate" (Emphasis added). The Fifth Circuit in *Smallwood*, rejecting the "might" test, said there is no evidence of any desire by this Court to "relax the standard of materiality to a mere possibility of influence on a reasonable investor, a standard implied by the word 'might.'" In marked and avowed contrast, the Seventh Circuit expressly rejected Judge Friendly's "standard

tending toward probability", stating as its reason that "once an element of probability becomes a part of the materiality test, a mere showing of relevancy of omitted facts is inadequate to establish a violation of 14a-9 or 10b-5" (A-10, note 13).

The conflict among circuits is whether materiality is to be equated simply with relevancy or limited to those facts which are of sufficient significance to have a *probable* impact on the shareholders' decision. Despite Respondent's protestations to the contrary, the test of materiality actually used by the federal courts has a very real "practical capacity to decide concrete cases" and is plainly not what Respondent dubs a "grammarian debate" (Br. 13).

Take *Smallwood,* for instance. *Smallwood* involved an omission in a merger proxy statement of the fact that Albert Range, who was an officer of Pearl (the merging company), was promised a stock option of 25,000 shares by the Board Chairman of Southdown, the surviving company. Relying on *Mills,* the Fifth Circuit held this omission not material as a matter of law in light of other disclosures which were made that "Range was to become a director of Southdown, that he was to be employed under a written contract for $75,000 annually and that Southdown had a qualified stock option plan." The Fifth Circuit said that "Although Pearl shareholders were not advised of the full extent of the merger's possible value to Range, they were 'sufficiently alerted' to Range's interests 'to be on their guard' " 489 F.2d 579, 604.

The Seventh Circuit, under its test, would have been compelled to reach a contrary conclusion on the *Smallwood* facts, since the omitted fact was clearly relevant and not trivial. Indeed the facts omitted in *Smallwood* were of greater consequence than the omissions in question here.*

* Respondent mistakenly asserts that the Seventh Circuit, under its test, also found one omission not to be material. However, the claimed omission, *i.e.* National's control over TSC, was expressly found not to be "a fact" but instead to pose an issue of fact about which there was "a bona fide dispute" under Rule 56 F. R. C. P. (A6).



C.

**Mills' Facts Differ Basically From Factual Issues in This Summary Judgment Record.**

To assert that, whatever the standard of materiality, the Seventh Circuit's result here is compelled by this Court's decision in *Mills* because "the match is complete" between the facts in *Mills* and the facts here (B. 7), is just a last-ditch argument which ignores the obvious and compelling differences between the facts here and in *Mills.* Those significant factual differences and disputes left Judge McLaren no choice but to deny Respondent's motion for partial summary judgment (A36-38).

It was not this Court* but the Seventh Circuit which held the *Mills'* 108-page proxy statement inadequate in describing fairly the proposed merger between Auto-Lite and Mergenthaler. 403 F.2d 429, 433-5 (7th Cir. 1968). On page 2 of that proxy statement it was stated in bold type that the Board of Directors of Auto-Lite believed the merger to be "fair and equitable to the shareholders of Auto-Lite". However, buried on page 23 was the fact that four of the eleven Auto-Lite directors were also directors of Mergenthaler. Nowhere was it admitted that seven of the Auto-Lite directors were Mergenthaler's nominees or that the remaining four directors were "kept" board members who continued to serve only at the pleasure of Mergenthaler and American. Except for a passing reference on page 2, the discussion of Mergenthaler's 54% ownership of Auto-Lite also appears on page 23. The Seventh Circuit there held that "under the circumstances the board was not free to state its recommendation and opinion favoring the merger without giving *similar emphasis* to the relationship between the directors and the other party to the bargain" [Emphasis added] 403 F.2d at 434.

* 396 U.S. at 381 n.4.

In basic contrast, in this case Judge McLaren held that:

> "Unlike the proxy statement dealt with in *Mills*, the joint proxy statement complained of here gives *similar emphasis* to the board's recommendation, National's equity interest in TSC and the number and some of the positions of National's nominees" [Emphasis added] (A37).

All of the information referred to by Judge McLaren was printed under headings of equal size on pages 6-7 of the Proxy Statement and those pages are reproduced as an Exhibit to the Petition. The sharp contrast between the essential facts in *Mills* and the facts Judge McLaren evaluates in this partial summary judgment record illustrates the difference between misleading statements and omissions which have a "significant propensity to affect the voting process" and those omissions which cannot be so classified. In *Smallwood* the Fifth Circuit found the omission of information about the stock option was not material as a matter of law and, at the same time, correctly observed that the omission could be found to be material after trial by the jury. 489 F.2d 604-5. Likewise here.

D.

**Materiality Test Is Crucial in the Seventh Circuit's Decision Improperly Foreclosing a Trial of Disputed Fact Issues.**

Respondent also asserts that the summary judgment record so adequately and clearly establishes the materiality of the complained of omissions as a matter of law that a departure from the *Mills* principles by the Seventh Circuit in this case would be of no consequence. From this Respondent concludes that the Petition is "an invitation to useless *obiter dictum*" (Br. 6). The Seventh Circuit's opinion dooms this approach and shows clearly that the test of materiality utilized was crucial to the result which the panel reached.



Judge McLaren had denied Respondent's motion for partial summary judgment by applying the "significant propensity" test in reliance on *Mills*. In order to show the District Court's judgment should be reversed, the Seventh Circuit first was compelled to reject what Judge Swygert called the "stricter propensity test" (A8) which had been followed by Judge McLaren. Next, the Court of Appeals expressed and adopted its "might have" test, which it recognized would comprehend "many facts" not coming within the significant propensity test. The detailed discussion of the different tests of materiality in the Seventh Circuit opinion, and its clear rejection of one and adoption of the other, is repugnant to Respondent's suggestion that the choice of tests is mere *dicta* (A7-13). Had the Seventh Circuit thought the omissions were material as a matter of law regardless of the standard used (Br. 6), there would have been no occasion for the panel's detailed analysis and emphasis on the test of materiality and its express rejection of the previously articulated standard.

It was the adoption of the "might have" or "relevancy" test which enabled the Court of Appeals first to isolate and then to find material undisclosed facts which, under the "significant propensity" test, would, as in *Smallwood*, "be viewed as unnecessary detail because stockholders were sufficiently alerted * * * to be on their guard" by the disclosed facts. Similarly, it was the adoption of the relevancy test which enabled the Seventh Circuit to determine the materiality of the various claimed omissions, contrary to Judge McLaren, without benefit of trial, and hence produced an abuse of the summary judgment device. Thus, even though relevant, the undisclosed facts concerning the purchases and value of National's securities could meet the "significant propensity" test for materiality only if after trial, there was evidence to establish collusion, manipulation of the market and distortion of value.

E.

**SEC's Post-Facto Amicus Position Is Neither Timely Nor Persuasive.**

Respondent seeks to reinforce its contention that the facts omitted in the Proxy Statement were "material" by relying on the *amicus curiae* brief filed in the Seventh Circuit by the SEC, "the responsible and expert agency in the field" (Br. 5). However, the SEC gave no support to the Seventh Circuit's new test of materiality. In addition, as this Court noted in *United Housing Foundation, Inc.* v. *Forman* (decided June 16, 1975, Slip Opinion, p. 19, note 24), the SEC's views are not entitled to much weight where the SEC does not speak with a single and consistent voice. Here the Commission has been singing more than one song.

In 1969 and now the SEC pointedly urges that prospectuses avoid unnecessary detail. Currently, Guide No. 5 of the SEC's Guides for Preparation and Filing of Registration Statements, Securities Act Release #4936, as amended states:

> "In order to make prospectuses more readable and understandable, and therefore more useful, Registrant should limit their length and complexity by careful organization of the material, . . . and the avoidance of . . . *unnecessary detail.*" [Emphasis added]

The SEC's Division of Corporation Finance, which examined and cleared the Proxy Statement in November, 1969, did not regard as material the factual matters later claimed to be material omissions in the SEC's *amicus curiae* brief. That brief was signed by members of the SEC's Office of General Counsel late in 1974. No doubt the Division in 1969 sought to avoid requiring unnecessary detail. Manifestly, the General Counsel's Office had nothing to do with the clearance of the Proxy Statement—five years before. The additional information which the SEC *amicus curiae* brief below argued to be "material" fits



neatly within the scope of "unnecessary detail". Its inclusion is plainly not conducive to the preparation of clear, concise and simple registration or proxy statements (Pet. 9-13).

Respondent complains that no mention was made of the fact that "a series of three official reports had been filed with the SEC by both TSC and National, only a matter of months before the Proxy Statement was mailed, in order to report that National may be deemed to be the parent of TSC. . . ." (Br. 3). Omission of any reference to those prior SEC filings was argued to be material in the SEC brief and found to be material as a matter of law by the Seventh Circuit. Yet, the staff of the Division of Corporation Finance, with whom these filings were made and who plainly must have been aware of them when they reviewed and cleared the Proxy Statement, did not regard those prior filings as sufficiently important to require any reference to them in the Proxy Statement.

In light of the plain and prominent disclosures in the Proxy Statement of the operative facts upon which the possibility of control by National existed (*i.e.*, National's 34% stock ownership of TSC and five National nominees on TSC's Board), this determination of the Division of Corporation Finance is far more consistent with the Commission's published admonition against the inclusion of "unnecessary details" than the *amicus curiae* brief filed five years later by another Division of the Commission having no past or present responsibility in the clearance of proxy material.

## CONCLUSION.

The Petition for Writ of Certiorari should be granted.

Respectfully submitted,

JOSEPH N. MORENCY, JR.,
JAMES T. OTIS,
WESLEY S. WALTON,
JOHN R. F. BAER,
PRICE, CUSHMAN, KECK,
MAHIN & CATE,
8300 Sears Tower,
233 South Wacker Drive,
Chicago, Illinois 60606,
312/876-3400,
*Attorneys for Petitioners.*

Of Counsel:
MILTON V. FREEMAN,
ARNOLD & PORTER,
1229 Nineteenth St., N.W.,
Washington, D. C. 20037.

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